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TAX PROVISIONS AFFECTING LOW-INCOME RENTAL HOUSING

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OF THE

COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled hearings on March 2-3, 1988, on tax provisions affecting low-income rental housing. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax provisions and a discussion of the tax issues relating to low-income housing.

The first part of the pamphlet is a summary. The second part describes the present-law tax credit for low-income housing, the 1987 proposed amendments to the credit (H.R. 3545),[1a] issues related to the credit and proposed changes, and the passive loss rules relating to low-income rental housing. The third part describes the provisions of H.R. 3663 (the Low-Income Housing Tax Act), introduced by Congressmen Rangel and Frank, as well as issues related to the bill.

Appendix A discusses economic issues relating to tax preferences for low-income rental housing, and Appendix B provides an overview of Federal low-income rental housing assistance programs.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Provisions Affecting Low-Income Rental Housing* (JCS-288), March 1, 1988.

[1a] Certain technical and other amendments were passed by the House of Representatives in October 1987, but which were not included in the bill as enacted.

I. SUMMARY

Tax credit

A tax credit may be claimed by owners of newly constructed, rehabilitated, and newly acquired existing residential rental property used for low-income housing. The credit is claimed annually, generally for a period of 10 years. For buildings placed in service after 1987, the credit percentages are adjusted monthly for buildings placed in service in that month to maintain a present value of the credit stream of 70 percent for qualified expenditures for most newly constructed and rehabilitated housing. In the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies (including tax-exempt bonds), monthly adjustments are made to maintain a 30-percent present value for the credit.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. Low-income tenants for purposes of the low-income housing tax credit are defined as tenants having incomes equal to or less than either 50 percent or 60 percent of the area median income, adjusted for family size. The qualifying income for a particular property depends on the minimum percentage of units that the owner elects to provide for low-income tenants. Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low," also adjusted for family size.

To qualify for the credit, a low-income housing project must continuously comply with all requirements for the credit for a period of 15 years. Each State receives an annual credit volume limit of $1.25 per resident. A credit allocation from the appropriate State or local government credit authority must be received by the owner of the property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the State's private activity bond volume limitation.

Basis

A taxpayer's basis in property generally is the property's cost, i.e., the amount of cash paid and the value of any other property transferred in exchange for the property. Basis is adjusted downward by the amount of depreciation or amortization deductions claimed against taxable income with respect to the property. On disposition of property, a taxpayer generally recognizes gain equal to the excess of (1) the amount realized over (2) the adjusted basis of the property.

Cooperative housing

Cooperative housing corporations and their tenant-stockholders are subject to special rules under the Internal Revenue Code.

H.R. 3545, as passed by the House

H.R. 3545 (Omnibus Budget Reconciliation Act of 1987), as passed by the House of Representatives in October 1987, would have provided certain technical and other modifications to the low-income housing tax credit as enacted in the Tax Reform Act of 1986. These amendments were not enacted in the 1987 Act. Some of the provisions included in H.R. 3545 are identical to those in H.R. 3663.

H.R. 3663

H.R. 3663 would restore an owner's basis in low-income rental housing to its original cost if the owner agreed to maintain the property as low-income housing for a 20-year period, thereby permitting the owner to resume claiming depreciation deductions. The bill also would allow (1) expanded use of the low-income rental housing tax credit; (2) an exclusion from tax of noncash gain on such housing sold to a purchaser who agreed to maintain the building as low-income rental housing for 20 years; and (3) a waiver of certain restrictions in the case of cooperative housing corporations.

II. TAX CREDIT AND PASSIVE LOSS RULES RELATING TO LOW-INCOME RENTAL HOUSING

A. Tax Credit for Low-Income Rental Housing

1. Present law and amendments passed by the House in 1987

Present Law

Overview

A tax credit may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually at a fixed rate, generally for a period of 10 years. For buildings placed in service after 1987, the credit percentages are adjusted monthly to maintain a present value of the credit stream of 70 percent for qualified expenditures for most newly constructed and rehabilitated housing for property placed in service in any month. In the case of acquisition costs of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies (e.g., tax-exempt bonds), monthly adjustments to the credit percentage are made to maintain a 30-percent present value for the credit.[2]

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. Low-income tenants for purposes of the low-income housing tax credit are defined as tenants having incomes equal to or less than either 50 percent or 60 percent of area median income, adjusted for family size. The qualifying income for a particular property depends on the minimum percentage of housing units that the owner elects to provide for low-income tenants. Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low", also adjusted for family size.

As stated above, the credit generally is claimed in equal annual amounts during the first ten years after the qualified property is placed in service.[3] To qualify for the credit, however, the low-income housing project must continuously comply with all requirements of the Internal Revenue Code for a period of 15 years.

Each State receives an annual credit volume limit of $1.25 per resident. A credit allocation from the appropriate State or local government credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt

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[2] New construction and rehabilitation expenditures for most low-income housing projects placed in service in 1987 were eligible for a maximum nine percent credit per year for 10 years. The acquisition cost of existing projects and the cost of newly constructed projects receiving other Federal subsidies placed in service in 1987 were eligible for a maximum four percent credit per year for 10 years.

[3] A credit percentage equal to two-thirds of the credit percentage for the initial qualified basis is applicable to additions to qualified basis, discussed below.

bonds subject to the State's private activity bond volume limitation.

Determination of credit amount

The credit amount for low-income housing in any taxable year is computed by applying the appropriate credit percentage to the qualified basis amount for that year.

Credit percentage

For buildings placed in service after 1987, the credit percentage is determined monthly, to achieve a present value of either 70 percent (most newly constructed and rehabilitated buildings) or 30 percent (existing buildings and all Federally subsidized buildings). The discount rate used to determine present value is an after-tax average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations for the month the building is placed in service.[4]

Present law, as clarified by a technical amendment passed by the House of Representatives in 1987 (H.R. 3545), permits a building owner, with the consent of the applicable housing credit agency, to elect irrevocably to use the credit percentage for the month in which the taxpayer receives a binding commitment for a credit allocation from the credit agency or, in the case of a tax-exempt bond financed project for which no allocation is required, the month in which the tax-exempt bonds are issued.

The credit percentage for rehabilitation expenditures (in excess of a prescribed minimum amount) is determined when rehabilitation is completed and the rehabilitated property is placed in service, but no later than the end of a prescribed 24-month period for which such expenditures may be aggregated.

Qualified basis

In general.—The qualified basis amount with respect to which the credit is computed is determined as the ratio of eligible basis in a qualified low-income building attributable to the low-income rental housing units. This ratio is the lesser of (1) the ratio of low-income units to all residential rental units or (2) the ratio of the floor space of the low-income units to the floor space of all residential rental units. Generally, in these calculations, low-income units are those housing units occupied by low-income tenants, whereas residential rental units are all housing units, whether or not occupied.

The qualified basis for each building is determined on the last day of each taxable year, beginning in the taxable year in which the building is placed in service or, if the taxpayer elects, the following taxable year.

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[4] Treasury's monthly adjustments of the credit percentages are to be determined on a discounted after-tax basis, based on the average of the annual applicable Federal rates (AFR) for mid-term and long-term obligations for the month the building is placed in service. The after-tax interest rate is to be computed as the product of (1) the average AFR and (2) .72 (one minus the maximum individual Federal income tax rate). The discounting formula assumes each credit is received on the last day of each year and that the present value is computed as of the last day of the first year.

Additions to qualified basis.—The qualified basis of a building may be increased subsequent to the initial determination only by reason of an increase in the number of low-income units or in the floor space of the low-income units (as opposed to by reason of increases in the eligible basis of the building). Credits claimed on such additional qualified basis are determined using a credit percentage equal to two-thirds of the applicable credit percentage allowable for the initial qualified basis. As described below under the description of the State credit ceiling, an allocation of credit authority must be received for credits claimed on additions to qualified basis, in the same manner as for credits claimed on the initial qualified basis. Unlike credits claimed on the initial qualified basis, credits claimed on additions to qualified basis are allowable annually for the portion of the required 15-year compliance period remaining after eligibility for such credits arises, regardless of the year such additional qualified basis is determined. The additional qualified basis is determined as a percentage increase in the original adjusted basis (before deductions for depreciation) of the property.

Eligible basis

Eligible basis consists of (1) the cost of new construction, (2) the cost of rehabilitation, or (3) the cost of acquisition of existing buildings acquired by purchase (including the cost of rehabilitation, if any, to such buildings incurred before the close of the first taxable year of the credit period and which do not exceed $2,000 per unit). Only the adjusted basis of depreciable property may be included in eligible basis. The cost of land is not included in eligible basis.

Generally, the eligible basis of a building is determined at the time the building is placed in service. For this purpose, rehabilitation expenditures (in excess of $2,000 per unit) are treated as placed in service at the close of the period when rehabilitation expenditures are incurred, not to exceed 24 months. In the case of rehabilitation expenditures incurred in connection with the acquisition of an existing building (and which do not exceed the $2,000 threshold amount), capital expenditures incurred through the end of the first year of the credit period may be included in the original eligible basis.

Acquisition of existing buildings.—The cost of acquisition of an existing building may be included in eligible basis and any rehabilitation expenditures to such a building incurred before the close of the first year of the credit period may at the election of the taxpayer also be included in eligible basis, without a minimum rehabilitation requirement. These costs may be included in eligible basis, however, only if the building or a substantial improvement to the building has not been previously placed in service within 10 years and if the building (or rehabilitated property within the building) is not subject to the 15-year housing credit compliance period.

A building that is transferred in a transaction where the basis of the property in the hands of the new owner is determined in whole or part by the adjusted basis of the previous owner (for example, by a gift of property) is considered not to have been newly placed in service for purposes of the 10-year requirement. Further, present law, as clarified by a technical amendment passed by the House in 1987 (H.R. 3545), provides that a building which has been acquired

by a governmental unit, or certain qualified 501(c)(3) or 501(c)(4) organizations is not treated as placed in service by that governmental unit or organization for purposes of the 10-year requirement, if the acquisition occurred more than 10 years from the date the building or a substantial improvement to the building was last placed in service. Further, a building acquired by foreclosure by taxpayers other than a governmental unit or 501(c)(3) organization is not treated as newly placed in service by that taxpayer for purposes of the 10-year requirement if the foreclosure occurred more than 10 years from the date the building or a substantial improvement to the building was last placed in service and the property was resold within a short period.

The Treasury Department may waive the 10-year requirement for any building substantially assisted, financed, or operated under the Department of Housing and Urban Development (HUD) section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration (FmHA) section 515 program when an assignment of the mortgage secured by property in the project to HUD or FmHA otherwise would occur or when a claim against a Federal mortgage insurance fund would occur.

Federal grants and other subsidies.—Eligible basis may not include the amount of any Federal grant, regardless of whether such grant is included in gross income. If any portion of the eligible basis attributable to new construction or to rehabilitation expenditures is financed with Federal subsidies (e.g., tax-exempt bonds), the qualified basis is eligible only for the 30-percent present value credit, unless such Federal subsidies are excluded from eligible basis.

Minimum set-aside requirement for low-income individuals

In general

A residential rental project qualifies for the low-income housing tax credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size.[5] (This requirement is referred to as the "minimum set-aside" requirement.)

A special set-aside may be elected for projects that satisfy a stricter requirement and that significantly restrict the rents on the low-income units relative to the other residential units in the building (the "rent skewing" set-aside). Projects qualify for this rule only if, as part of the general set-aside requirement, 15 percent or more of all low-income units are occupied by individuals having incomes of 40 percent (rather than 50 percent or 60 percent) or less of area median income, and the average rent charged to tenants in the residential rental units which are not low-income units is at

[5] A special set-aside requirement under which a project qualifies if 25 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income is provided for New York City.

least 300 percent of the average rent charged to low-income tenants for comparable units. Under this special rule, a low-income tenant will continue to qualify as such, as long as the tenant's income does not exceed 170 percent (rather than the general 140 percent limit, described below) of the qualifying income. Additionally, if a project to which this special set-aside requirement applies ceases to comply with the continuous compliance requirement because of increases in existing tenants' incomes, no penalties are imposed if each available low-income unit (rather than each available unit) is rented to tenants having incomes of 40 percent or less of area median income, until the project is again in compliance.

All units comprising the minimum set-aside in a project must be suitable for occupancy and used on a nontransient basis, and are subject to the limitation on gross rent charged to residents of set-aside units.

The owner of each project must irrevocably elect the minimum set-aside requirement (including the rent skewing set-aside described above) at the time the project is placed in service. In the case of a project consisting of a single building, the set-aside requirement must be met within 12 months of the date the building (or rehabilitated property) is placed in service, and complied with continuously thereafter for a period ending 15 years after the first day of the first taxable year in which the credit is claimed. Special rules apply to projects consisting of multiple buildings placed in service on different dates.

Continuous compliance required

The determination of whether a tenant qualifies as low income for purposes of the minimum set-aside requirement is made on a continuing basis, both with regard to the tenant's income and the qualifying area income, rather than only on the date the tenant initially occupies the unit. An increase in a tenant's income may result, therefore, in a unit ceasing to qualify as occupied by a low-income person. However, a qualified low-income tenant is treated as continuing to be such notwithstanding *de minimis* increases in his or her income. Under this rule, a tenant qualifying when initially occupying a rental unit will be treated as continuing to have such an income provided his or her income does not increase to a level more than 40 percent in excess of the maximum qualifying income, adjusted for family size. If the tenant's income increases to a level more than 40 percent above the otherwise applicable ceiling (or if the tenant's family size decreases so that a lower maximum family income applies to the tenant) that tenant is no longer counted in determining whether the project satisfies the set-aside requirement. No penalty is assessed in such an event, however, provided that each residential rental unit that becomes vacant (of comparable or smaller size to the units no longer satisfying the applicable income requirement) is rented to low-income tenants until the project is again in compliance.

Vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by qualified low-income individuals for purposes of the set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to

rent the units and no other units of comparable or smaller size in the project are rented to nonqualifying individuals.

Gross rent limitation

The gross rent paid by families in units on which a tax credit is claimed may not exceed 30 percent of the applicable area income qualifying as "low," adjusted for family size. Gross rent includes the cost of any utilities, other than telephone. If any utilities are paid directly by the tenant, the maximum rent that may be paid by the tenant is reduced by a utility allowance prescribed by the Treasury Department.

The gross rent limitation applies only to payments made directly by the tenant. For example, any rental assistance payments made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, are not included in gross rent for purposes of the 30-percent limit. (Such payments are, however, included in determining gross rent for purposes of the special exception for rent-skewed projects.)

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set-aside requirement, described above, throughout a 15-year compliance period. Units on which credits are claimed in addition to those meeting the minimum set-aside requirement on which a credit is allowable also must continuously comply with this requirement.

Generally, any change in ownership of a building subject to the compliance period is a recapture event. An exception is provided if the seller posts a bond with the Treasury Department (in an amount prescribed by Treasury) and provided it can reasonably be expected that the building will continue to be operated as a qualified low-income building for the remainder of the compliance period. For partnerships comprised of at least 35 individual partners and where no more than 50 percent of the ownership is by corporations, at the partnership's election, no change in ownership will be deemed to occur provided within a 12-month period at least 50 percent (in value) of the original ownership is unchanged.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project is recapture of a portion of all credits claimed, with interest, for all prior years.

The penalty for a decrease in the qualified basis of a building, while still remaining part of a qualified low-income project, is recapture of the credits with respect to the accelerated amount claimed for all previous years on the amount of the reduction in qualified basis.

Owners and operators of low-income housing projects on which a credit has been claimed may correct any noncompliance with the set-aside requirement within a reasonable period after the noncompliance is discovered or reasonably should have been discovered, in which case there is no recapture.

State low-income housing credit authority limitation

Generally, all buildings eligible for the low-income housing credit must receive an allocation of credit authority from the State or local credit agency in whose jurisdiction the qualifying low-income housing project is located. The aggregate amount of such credits allocated within the State is limited by the State annual low-income credit authority limitation. Generally, credits subject to the State credit authority limitation include any credits attributable to expenditures not financed with tax-exempt bonds subject to the private activity bond volume limitation.

In all cases, credit allocations are counted against a State's annual credit authority limitation for the calendar year in which the credits are allocated. Credits may be allocated only during the calendar year in which the building or rehabilitated property is placed in service, except in the case of (1) credits claimed on additions to qualified basis and (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service.

Allowable credit authority

General rules.—The annual credit authority limitation for each State is equal to $1.25 for every individual who is a resident of the State. For purposes of the credit authority limitation, the District of Columbia and U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are treated as States. No credits authority is provided for years after 1989.

Generally, no carryover of unused credit authority is permitted. A limited exception is provided for buildings placed in service in 1990, if expenditures of 10 percent or more of total project costs are incurred before January 1, 1989. Credit authority for such property may be carried over from the 1989 credit authority of issuing the credit agency.

Present law, as clarified by a technical amendment passed by the House in 1987 (H.R. 3545), provides that, for allocations made after 1987, if a building cannot be placed in service in the year for which the allocation was made for reasons beyond the control of the taxpayer, then upon approval by the Treasury Department, the credit allocation will be valid if the building is placed in service in the succeeding year.

Special set-aside for qualified nonprofit organizations.—A portion of each State's credit authority limitation is set aside for exclusive use by qualified nonprofit organizations. This set-aside is equal to $0.125 per resident of the State. This set-aside amount may not be changed by State action, either legislative or gubernatorial. In addition to the special set-aside, qualified nonprofit organization projects may be allocated any additional amount of a State's remaining credit authority.

Description of Amendments to the Low-Income Housing Credit Passed by the House in 1987 (H.R. 3545)

The House of Representatives passed H.R. 3545 in 1987, which would have made numerous technical and substantive modifications to the low-income housing credit. These amendments were

not enacted into law. Below follows a brief description of the substantive amendments to the credit which were included in H.R. 3545, as passed by the House (but which were not included in the bill as enacted).

Carryover of credit authority and reduction in credit volume limitations

H.R. 3545 would have permitted States to elect to carryover unused credit authority for specifically identified projects that would be placed in service in the following calendar year. The carryover authority would have applied only to costs eligible for the 70-percent present-value credit, unless the costs were restricted to the 30-percent credit solely because of the presence of another Federal subsidy. Concomitantly, the bill would have reduced each State's credit volume limitation from $1.25 per resident of the State to $1.10 per resident.

Determination of low income

H.R. 3545 would have provided that the determination of whether a tenant's income qualified as "low" could be made by reference to either the area median income or the State median income, which ever was higher.

Determinations of qualifying rent

H.R. 3545 would have excluded rental assistance payments under section 8 of the Housing Act of 1937 from gross rent in determining whether a project qualified for the special set-aside for projects in which low-income tenants are charged gross rents not exceeding one-third of the rent charged to other tenants.

H.R. 3545 also would have permitted the owner of a low-income housing credit project to disregard changes in family size resulting from death, divorce, separation, and abandonment in determining the gross rent that may be charged an existing low-income tenant in such a project.

Exceptions to 10-year anti-churning rule

H.R. 3545 would have expanded the exceptions to the 10-year anti-churning rule for certain Federally subsidized housing to permit the Secretary of the Treasury to grant exceptions, on a case-by-case basis, to rental housing receiving subsidies under section 236 and 221(d)(3) programs, if the Secretary determined that failure to grant a waiver will result in conversion to a use other than low-income housing.

The bill also would have expanded an exception from the 10-year anti-churning rule for existing housing if the building were owned and operated by a governmental unit provided that the building's previous private owner had placed the building in service at least 10 years before. This exception also would have applied to governmentally owned buildings originally placed in service fewer than ten years ago, if the governmental unit originally placed the building in service and had continuously owned and operated it since that date.

Recapture on corporate partnerships

H.R. 3545 would have deleted the limit on corporate ownership for certain large partnerships where credit recapture liability is determined at the partnership, rather than the partner, level.

2. Issues arising from proposals to amend the low-income housing tax credit

The tax credit for low-income rental housing enacted in 1986 created a new tax subsidy for real estate at a time when tax benefits for real estate generally were being reduced. The credit was designed to direct tax incentives more efficiently to low-income individuals by linking the incentive to the number of low-income individuals served and requiring that individuals with incomes lower than previously required be served.[6] Additionally, limits were placed on rents that may be charged to tenants in residential units receiving tax credits.

H.R. 3545, as passed by the House of Representatives in 1987, contained numerous amendments to the low-income housing credit, both of a technical and of a substantive nature. Two main goals lay behind the substantive provisions in the bill. One goal was to make the low-income rental housing tax credit more attractive to investors. Attracting more investors could increase construction of new (or rehabilitated) housing. The other goal was to enable the tax credit to be used to help preserve the existing low-income housing stock in low-income use, and to extend to this stock the new targeting requirements of the credit.

Increasing the pool of investors

In general, the efficacy of increasing the pool of investors in low-income housing depends on the extent to which States are using their existing tax credit authority. If States fully utilize their present-law credit authority, increasing the pool of investors may change the nature of the projects undertaken, but may not necessarily increase the supply of low-income rental housing. Early evidence suggests only moderate use of credit authority in 1987.[7] This may reflect the newness of the tax credit as well as the numerous other changes made by the Tax Reform Act of 1986, rather than the potential long-term usage of the credit. In addition, while potentially successful at expanding the use of the tax credit, some of the proposals contained in H.R. 3545 raise other issues.

Carryover of credit authority

Present law, as clarified by a technical amendment passed by the House in 1987 (H.R. 3545), permits such carryovers where a project could not be placed in service due to unavoidable circumstances beyond the control of the developer. A substantive amendment in H.R. 3545 would have permitted carryovers in the case of new con-

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[6] *See, General Explanation of the Tax Reform Act of 1986,* Joint Committee on Taxation (JCS-10-87, May 4, 1987), pp. 152-153.

[7] *See,* C. Herbert, and J. Verdier, *Early Experience with the Low-Income Rental Housing Tax Credit,* National Council of State Housing Agencies, October 1987.

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struction and rehabilitation projects without regard to such special circumstances.

Present law amendment protects investors from the uncertainty of weather and other unavoidable delays which affect the construction business. The substantive amendment would increase flexibility for investors in determining when to place their projects in service. This increased flexibility makes the credit more attractive.

The efficacy of credit carryforward depends on the extent to which investors apply for the credit under current law. If 1987's experience was not indicative of the long-run utilization of the credit, the amendment could lead to small or no net additions of low-income housing. Furthermore, since in the bill, carryforward would be accompanied by a reduction in State credit authority the result could be fewer additions to the stock of low-income housing than present law would provide.

Recapture of credits

Another substantive amendment in H.R. 3545 would have expanded the partnerships eligible for a special, relaxed recapture provision on low-income rental housing credits. Present law, as clarified by a technical amendment passed by the House in 1987 (H.R. 3545), permits limited interests in these partnerships to be owned by corporations (who are not subject to the passive loss restrictions) to reflect the fact that developer corporations frequently retain a limited interest in projects syndicated by them.

Present law provides greater flexibility in attracting investors who are not subject to the limitations of present law limiting deductibility of losses from passive activities.

The substantive amendment would remove all limits on corporate ownership of partnerships eligible for the special recapture rule. Making recapture less likely could enhance the attractiveness of credit projects to corporate investors generally. On the other hand, removing the threat of recapture could lessen the commitment of corporate investors (not subject to the passive loss limitation) to continued maintenance of low-income rental housing projects.

Changes in family size

H.R. 3545 would have provided that decreases are not made in a low-income tenant's rent to reflect certain reductions in family size. Not reducing a tenant's rent for certain reductions in family size provides greater certainty to investors in low-income housing. Providing this surety to investors' cashflow may create greater investor interest. This could result in expansion of the low-income rental housing stock. On the other hand, not requiring reductions in rent could impose a greater financial burden on persons who have lost a portion of their available family income and could reduce the targeting of subsidized units to families with the greatest need.

Determination of low income

Permitting an investor to use the higher of metropolitan statistical area ("MSA") or State income to determine what tenants qualify as having low-incomes, as would have been done under H.R.

3545, effectively raises the income limits applicable to potential rental housing projects. This in turn raises the maximum rent an investor may charge these tenants. (Low-income tenants may not be charged rents exceeding 30 percent of the income qualifying as "low" (e.g., 60-percent or 50-percent of the area income).)

Many statistical areas include a central city and its suburbs. Some areas, however, are defined solely by the central city. Incomes typically are higher in suburbs; hence income limits are more stringent where suburbs are not included in an MSA. This may create unequal treatment of such areas when they are in all other respects similar. However, permitting tenants in an area to qualify as having low incomes and charging rents based on the higher of State or area median income would effectively increase the credit income targets, thereby diminishing the effectiveness of targeting tax credit projects toward lowest-income individuals.

Section 8 rental assistance

Under a special exception from the continuous compliance requirement for certain rent-skewed projects, rental assistance payments under section 8 of the Housing Act of 1937 are included in determining whether rents charged to low-income tenants are no more than 33 percent of those charged other tenants.[8] This rent-skewing exception reflects the economic difficulty which could arise if developers were required to charged reduced rents on multiple housing units (e.g., when a tenant's income increased above the low-income threshold but local law or economic factors precluded increasing the tenant's rent to the full market rate while a new low-income tenant was required to be admitted to the project as a result of the continuous compliance requirement).

Excluding section 8 rental assistance payments from the calculation of rent paid by the tenant could permit a tax-credit project to qualify under the rent-skewing exception while investors received full market rents on all housing units in the project (i.e., the combined tenant and section 8 payments could equal the full market rent charged non-low-income tenants). On the other hand, relieving projects from the requirement of subsidizing a housing unit at a below-market rent would increase project profitability and potentially investor interest.

Preserving the existing low-income housing stock

HUD estimates that the sections 221(d)(3) and 236 programs presently subsidize over 600,000 units of rental housing. HUD further estimates that mortgages on over 25 percent of these units are likely to be prepaid between now the the mid-1990s.[9] With prepayment of the HUD-subsidized mortgage, HUD loses control of the rents that tenants may be charged. These housing units may be converted to a non-subsidized rental housing or owner-occupied housing use as a result. This problem is less likely to occur for State-financed, non-FHA-insured projects which are subject to

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[8] This definition is more stringent than the general definition of gross rent. If this more stringent rule is satisfied, special relief is provided on the requirement that projects continuously serve minimum percentage of low-income tenants.

[9] *See*, G., Milgram, *The Assisted Housing Stock: Potential Losses from Prepayment and "Opt-outs"*, Congressional Research Service, Report 87-879 E (November 4, 1987).

State control. Most, if not all, of these mortgages prohibit prepayment.[10]

Permitting selective use of the low-income housing credit on some of these housing projects could encourage their retention as subsidized rental housing. Concomitantly, the tax credit's targeting rules would be extended to these projects, many of which currently qualify for these outlay provisions under more relaxed rules.

On the other hand, permitting waivers of the rule restricting tax credits to projects that have not been placed in service within the 10 years preceding the credit-eligible transfer may not be the most effective way to assure a stock of low-income rental housing. Much rental housing serving low-income households originally was not built as low-income housing. Rather, as the housing aged and more new housing was built, the older housing became affordable and available to low-income families. Present law gives the most tax credit for the creation of new or the rehabilitation of housing units. One of the credit's objectives was to provide an incentive to expand and upgrade the nation's low-income housing stock by more than the private market alone would dictate. Expanding the circumstances under which waivers of the 10-year anti-churning rule may be granted by Treasury without imposing a substantial rehabilitation requirement may eliminate incentives to increase or improve the stock of low-income rental housing.

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[10] *Ibid.*

B. Restrictions on Deductions and Credits Arising from Passive Activities

Passive loss rules in general

The Tax Reform Act of 1986 added a provision limiting losses and credits from passive activities (i.e., activities in which the taxpayer does not materially participate, and rental activities). Under this provision, deductions from passive trade or business activities or rental activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his its interest in the activity.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations.

Special rules

$25,000 allowance in the case of rental real estate activities

A special rule is provided for passive activity losses and credits attributable to rental real estate activities. In the case of rental real estate activities, a taxpayer who is an individual is allowed to deduct up to $25,000 of passive activity losses (to the extent that they exceed income from passive activities) if the taxpayer actively participates in the rental real estate activity (and has at least a 10-percent interest in it). The $25,000 amount is phased out ratably as the taxpayer's adjusted gross income, with certain modifications, increases from $100,000 to $150,000.

Special rule for low-income housing and rehabilitation credits

Under a special rule, the $25,000 allowance applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the adjusted gross income phaseout range for the $25,000 amount for these credits is from $200,000 to $250,000 (rather than the generally applicable phaseout range of $100,000 to $150,000).

Effective date

The passive loss limitations are effective for taxable years beginning after 1986. For certain pre-enactment interests in passive

activities, the provision is phased in, and becomes fully effective for taxable years beginning in 1991 and thereafter. Transitional relief is provided for losses from certain existing low-income housing activities.

III. DESCRIPTION OF H.R. 3663

("The Low-Income Housing Tax Act of 1987")

A. Present Law and Provisions of the Bill

Present Law

In general

A taxpayer's basis in property for tax purposes is generally its cost, i.e., the amount of cash paid and the value of any property transferred in exchange for the property. Basis includes the amount of any indebtedness incurred in connection with the acquisition of the property, and may be increased by the cost of any subsequent capital improvements. Basis is decreased by the amount of depreciation deductions claimed against taxable income with respect to the property. On disposition of property, a taxpayer generally recognizes gain equal to the excess of (1) the amount realized (i.e., the amount of cash and value of any property received for the property) over (2) the adjusted basis of the property. The amount realized generally includes the amount of any indebtedness on the property that the purchaser assumes or takes subject to, including nonrecourse indebtedness. Gain on disposition is taxed at the same rate as ordinary income; however, if the taxpayer has capital losses, the losses may offset portions of the gain not subject to recapture of past depreciation deductions in addition to the $3,000 of ordinary income allowed to be offset by net capital losses.

Tax credit for low-income rental housing

Present law provides a tax credit to owners of residential rental property providing low-income housing. This tax credit, as enacted in 1986, replaced tax incentives provided for low-income housing investments under prior law, i.e., preferential depreciation, five-year amortization of rehabilitation expenditures, and special treatment of construction period interest and taxes. Different amounts of credit are provided for new construction and rehabilitation of low-income housing and for acquisitions of existing housing.[11]

Cooperative housing corporations

Cooperative housing corporations and their tenant-stockholders are subject to special rules under the Code. A cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the shareholders of which is entitled, solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive

[11] For a description of the present-law rules relating to the low-income housing credit, see Part II.A.1., above.

any distribution not out of earnings and profits of the cooperative, except on liquidation of the corporation, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders (sec. 216).

The tenant-stockholders of a cooperative housing corporation are entitled to deduct their allocable shares of the interest and real estate taxes paid by the corporation. In general, the corporation itself is subject to tax in the same manner and at the same rates as regular corporations. Accordingly, rents received (whether from tenant-stockholders or commercial tenants) are includible in gross income, and depreciation and other business expenses are allowable as deductions.

The Code provides that a nonexempt membership organization that is operated primarily to furnish services or goods to members may deduct amounts attributable to the furnishing of such services or goods only to the extent of income derived from members. The Tax Court has held, in the case of one nonprofit membership corporation[12] organized to provide housing to low- and moderate-income tenants that the corporation was subject to this provision, and that investment income earned on replacement and general operating reserves funded by tenant-member contributions was not income derived from members for this purpose. Accordingly, such investment income could not be offset by depreciation on member units or by other member-related expenses. *See, Concord Consumers Housing Cooperative* v. *Comm'r*, 89 T.C. 105 (1987).

Explanation of the Bill

Additional tax benefits for certain property retained for use as low-income housing

The bill would provide special tax benefits to owners of certain low-income residential rental property. As a condition of receiving these benefits, the owner must agree to continue operating the property under existing restrictions imposed by a Federal, State, or local housing program for an additional period of 20 years, or the remaining term of any government-subsidized debt on the property, if longer. The owner also must agree to make capital contributions in an amount the appropriate government official determines to be necessary to restore the project to sound physical and financial condition.

One benefit provided under the bill is that the owner could increase its adjusted basis in the property to the original acquisition cost, plus the amount of any expenditures for capital improvements incurred before the agreement date. This restored basis would determine the future amounts allowable to the owner as depreciation on the property and the amount of gain on disposition of the property.

An additional benefit would be provided if 10 years have lapsed since the property was placed in service (or since the property was

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[12] Although the parties in the cited case stipulated that the taxpayer was incorporated as a "cooperative housing corporation," the court could not determine from the record whether it satisfied the definitional requirements of section 216; the court therefore did not assume such requirements were met.

substantially improved) and the low-income housing credit has not been claimed previously with respect to the property. In these circumstances, the owner would be treated as placing the property in service on the agreement date, thus qualifying for the low-income housing credit. The amount of the credit would be based on the restored basis, described above.

In the event the owner disposed of the property prematurely or otherwise failed to operate the property in accordance with the agreement, the owner would be required to pay a tax equal to the amount of the taxes saved in prior years, plus accrued interest from the year in which the benefit was received.[13]

Liberalization of requirements for low-income housing credit

The bill would allow waiver of the requirement under the low-income housing credit that a building have been placed in service at least 10 years before it was acquired by the taxpayer. This requirement would be waived in the case of any building substantially assisted, financed, or operated under a Federal, State, or local housing program, if either (1) the appropriate government official determined that the availability of the credit would help to avoid a default or reduce the loss to the government, or was necessary to enable the project to avoid default or be retained for low-income use, or (2) the taxpayer acquired the building from a governmental body which had acquired the building pursuant to a default.

Exclusion of gain on disposition of certain low-income housing property

The bill would allow a taxpayer (other than a corporation) who disposes of certain low-income housing property to exclude from gross income an amount equal to the excess of the indebtedness on the property over its adjusted basis. Thus, in general, the taxpayer would be taxed only to the extent he or she received cash or consideration other than assumption of qualified indebtedness. For the exclusion to apply, the property must have been assisted, financed or operated under a Federal, State, or local housing program, and have been subject to restriction on rents or income with respect to 20 percent or more of the tenants, for at least five years prior to the disposition. In addition, the disposition must be to a nonprofit tenants' organization, a nonprofit organization one of whose exempt purposes includes the fostering of low income housing, a State or local governmental unit, or a partnership that contributes sufficient capital to restore the project to sound condition.

Liberalization of rules applicable to cooperative housing corporations in the case of certain low-income housing projects

The bill would permit certain entities—"limited equity cooperative housing corporations" eligible for tax-exempt bond financing—to qualify as cooperative housing corporations without regard to the requirement that 80 percent or more of the corporation's income be derived from tenant-stockholders.

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[13] Presumably any remaining restored basis at the time of the recapture event would be eliminated immediately before such event. Thus, the gain realized on a disposition of the property would be determined without regard to the restored basis.

In addition, the bill would treat any income derived by a limited equity cooperative housing corporation from investment of mandatory reserves as income derived from members for purposes of the limitation on deductions by membership organizations. Thus, deductions for depreciation and other expenses of the corporation attributable to tenant-shareholders would be allowed to offset such investment income. The bill provides that, if a qualifying corporation later loses its status as a limited equity cooperative housing corporation, the tax benefit attributable to this treatment of investment income on reserves would be recaptured, with interest from the year in which the benefit was realized.

Effective Date

The bill generally would be effective for taxable years beginning after the date of enactment. In the case of a corporation qualifying as a limited equity housing corporation as of the first day of the first taxable year beginning after the date of enactment, the provisions would be effective, at the election of the taxpayer, for any prior taxable year.

B. Issues Arising Under H.R. 3663

H.R. 3663 is designed primarily to encourage the retention of existing low-income rental housing in that use. It attempts to achieve this goal by providing new tax incentives, by expanding the eligibility for the low-income housing credit to certain existing low-income housing properties, and by exempting some tenant cooperatives which may own or purchase such housing from certain income tax limitations.

New tax incentives for existing low-income housing

In general

The bill would provide two new tax incentives generally to owners of projects which already qualify as low-income housing. The first would increase the basis of the project for purposes of depreciation, gain recognition, and, if applicable, the low-income housing credit, if the owner agrees to maintain the project as low-income rental housing. The second would exclude a specified amount from the gain recognized if the project is sold to groups willing to maintain the property as low-income housing.

HUD estimates that the sections 221(d)(3) and 236 programs presently subsidize over 600,000 units of rental housing. HUD further estimates that mortgages on over 25 percent of these units are likely to be prepaid between now and the mid-1990s. With prepayment of the HUD-subsidized mortgage, HUD loses control of the rents that tenants may be charged. These housing units may be converted to a non-subsidized rental housing or owner-occupied housing use as a result. This problem is less likely to occur for State-financed, non-FHA-insured projects which are subject to State control. Most, if not all, of these mortgages prohibit prepayment.

Some believe that providing benefits for the continuance of existing low-income housing is a cost effective method for assuring affordable housing. Additionally, State and local housing authorities are able to guarantee, through the agreements required under the bill, the future availability of quality low-income housing. They are able to select properties which will particularly benefit from the incentives provided and require appropriate new investments in them.[14]

Others argue that providing incentives targeted primarily to existing property will generate little net increase in rental housing for low-income populations. Instead, they contend that much of the benefits will go to owners of property which would have remained low-income anyway. Also, property which is induced to retain its low-income status may displace other new or rehabilitated housing

[14] For a more complete discussion of these issues, see, II.A.2., *supra*.

that might have been available to low-income populations. Additionally, the particular level of tax incentive granted may bear little relation to the level of housing services provided by the project or the amount needed to assure the continued provision of low-income rental housing. Instead, the value of the proposed tax incentive to be granted depends on the particular historical pattern of investments associated with a property, in nominal rather than in inflation-adjusted dollars. Therefore, the benefit is only loosely related to age or the true worth of the project.

In addition, the incentive provided for new construction in this bill is very small relative to existing tax incentives. The proposed benefits are visible only far on the horizon for new development. Thus, it is suggested that these provisions may increase construction of low-income housing only slightly.

Basis restoration

Owners of low-income rental housing may have the option of selling the property in the open market. For property on which the low-income housing credit is desired and available, selling to a new owner will often be tax-favored relative to retention by the original owner, under present law. The buyer receives the benefit from a higher basis for calculating depreciation and receives the low-income housing tax credit on his or her acquisition cost. The buyer's tax benefit usually will outweigh the tax on any gain owed by the seller.

The bill encourages retention of low-income property by the current owner. It gives the current owner benefits equivalent to a sale and repurchase at a price equal to the acquisition cost plus improvements, not market value, while additionally excluding capital gain to the extent that acquisition and improvement costs exceed the basis. Even without the low-income housing credit, the restoration of basis generally will provide positive tax benefits to the current owner since the increased depreciation deductions are not offset by a tax liability on gain from disposition. Of course, in order to obtain these tax benefits, the current owner must commit to retain the property as low-income housing for 20 years or more.

In contrast, an actual sale where the low-income housing credit is not used will rarely provide net tax benefits. The tax paid on gain by the seller will usually exceed the value to the buyer of higher depreciation deductions.

The incentive from granting benefits specifically aimed at current owners may be limited if the new depreciation deductions generate passive tax losses. Much low-income housing has been owned by partnerships whose members may now be subject to the passive loss limitations of the Code. To the extent the passive loss limitations restrict the ability of current owners of existing properties to use additional tax deductions, the incentive from additional passive tax losses may be small. New investors in low-income rental housing may be better equipped to absorb passive tax deductions.

The incentive effects of the basis restoration further depend on the market value of the property, as well as the current basis and acquisition cost. Older property will have a low basis because of accumulated depreciation deductions. Further, the original acquisition cost may be low relative to the market value because of infla-

tion. If market value greatly exceeds the original acquisition cost, the relative benefit of the forgiveness of tax on gains on past depreciation deductions may be minor compared to other economic considerations. For example, for property which is eligible for the low-income housing credit and that has a high market value relative to basis and acquisition cost, a sale to a new owner who will obtain the low-income housing credit may generate a higher total value of tax deductions and credits than the bill would grant to the current owner of the property. However, in situations where market value greatly exceeds acquisition costs, the value of alternative uses of the property is high, and the property is unlikely to remain as low-income housing.

In the reverse case, where the market value of the property is low relative to the original acquisition and improvement costs, the tax benefits granted by the bill may be high relative to that obtainable through an actual sale and may be high relative to other economic considerations. Because the benefit is based on the spread between acquisition cost and basis, the value of the tax benefit obtained is an arbitrary amount that may bear little or no relationship to the market value of the property or its worth as quality low-income rental housing. Thus, much of the benefit of this provision may accrue predominantly to properties that have relatively low value; more valuable property either can be converted to other uses or use existing tax benefits for low-income housing. If the appropriate officials could successfully mandate renovations and improvements, however, the effect of obtaining lower worth property on the resulting quality of the low-income housing stock could be ameliorated.

If the property is to remain as low-income rental housing, a true sale will also expose the property to less restrictive use rules and less punitive potential recapture than that required by the bill. The credit requires a compliance period of 15 years compared to at least 20 years under the bill. If the property stops being used as low-income housing, the low-income rental housing credit rules require a recapture only of a portion of the credit plus interest. The bill would recapture all benefits granted under it for the whole compliance period, with interest, if the property is converted from low-income rental housing use at any time during the length of the agreement. For any property subject to an agreement, the recapture provisions under the bill are so substantial that they would probably deter conversion from low-income housing use. Thus, instead of entering the agreements, property owners might seek other market transactions in order to maintain flexibility in the future and avoid the potential penalties the bill would provide.

The benefit of the low-income housing credit generally swamps other available tax benefits. Virtually all of the existing low-income rental housing stock has not previously received the benefit of the low-income housing credit enacted in 1986 and thus may be eligible for the low-income housing credit in the future. For this property, it usually will be undesirable to enter into an agreement authorized under the bill before the project is eligible for the low-income housing credit. By that time the property often will have a relatively low basis, and the combination of exclusions, credits, and higher depreciation deductions may provide considerable encour-

agement to enter into an agreement, contingent, of course, on other economic considerations such as those described above. As long as the agreement is maintained, it will assure the property will have remained low-income housing for 30 years or more. Property which has in the past received the low-income housing credit and is therefore not again eligible for the credit will receive much less incentive.

For newer property which will not in the future be eligible for an additional low-income housing credit, the value of the basis restoration is much smaller and the timing, if any agreement is desired, will depend on circumstances specific to a property. The smaller incentive may become operative relatively early in the life of the property, and if an agreement is reached, it may bind the property for a shorter total life.

Capital gains exclusion

The bill would provide for nonrecognition of gain to the extent that transferred debt exceeds the basis of the property, upon disposal of low-income housing property by taxpayers (other than corporations) to certain entities which will agree to maintain the property as low-income housing for 15 years. This may encourage current owners to dispose of property so that its low-income rental status will be maintained.

The incentive from this capital gains exclusion will depend on the particular tax basis of the property and the level of debt. For example, suppose property worth $100 has a current basis of $70 and is encumbered by debt of $80. The property has a built-in gain of $30 which is the difference between market value and basis. If the property and debt are sold together, the buyer is willing to pay $20 (the difference between the value of the property and the value of the debt assumed). The seller would, under normal tax principles, recognize the full built-in gain of $30 which equals the sum of the $20 in cash received plus $10 which is the difference between debt and basis. In this example, the bill would, in a qualifying transaction, exempt $10—the difference between debt and basis. Alternatively, if one assumes that the taxpayer had maintained a debt of $95 on the property, $25 of the $30 gain would be excluded. Thus, more debt will generate a higher exclusion and lower capital gain tax.

It historically has been the practice to finance low-income housing almost completely and frequently to use debt that is insured by some governmental authority (e.g., the Federal Housing Administration) to enable the high leveraging. Taxpayers may wish to maximize use of the capital gain exclusion by maintaining as high a level of debt as possible for as long as possible. This added incentive for high leveraging may further increase the risk of default on the debt, increase the potential burden on governmental mortgage insurers, or perhaps reduce the future availability of private lending for low-income housing.

This particular exclusion may be considered by some as an appropriate incentive for low-income housing since it requires the seller to pay tax on an amount no greater the cash actually received. Others may believe, however, that the exclusion violates a

long established principle of tax law regarding taxation of gain with insufficient justification.

Expanded waiver authority for low-income housing credit

H.R. 3663 would permit the head of any governmental body which provides assistance to low-income housing to waive the 10-year anti-churning rule for eligibility to receive the low-income housing credit for any property which has defaulted or for which it is felt that the credit is necessary to avoid default or conversion from low-income use. This waiver would permit application of the low-income housing credit to property which had been placed in service less than 10 years ago.

Some consider that a natural extension of present law would be to grant to State and local government officials the right to waive the 10-year requirement that is currently available to Federal officials for some Federally-assisted projects which are at risk of default.

Others view the extension as transferring to State and local authorities the Federal Government's prerogative to determine the beneficiary of tax expenditures. The Federal Government has established a class of properties which are eligible for the low-income housing credit waiver. These projects were chosen with the rationale of permitting the Federal Government to substitute tax expenditures for budgetary outlays when this would provide a more attainable or a more cost effective result. When the the waiver is used to prevent default to State and local housing authorities, the waiver is not being used to minimize Federal costs but instead serves indirectly as a subsidy from the Federal Government to the State or local governmental body which is authorized to grant the waiver.

The extension of waiver authority can be thought of as allowing State and local officials more flexibility in allocating its credit authority. In this view, the officials should be able to use their available credit authority to generate the greatest stock of low-income housing regardless of its last placed in service date. Property at risk of conversion or imposing losses on governmental bodies responsible for encouraging low-income rental housing would appear to be a high priority for State housing officials.

On the other hand, some suggest that the Federal Government has carefully delineated the options available to State and local government low-income housing authorities. The 10-year rule is intended to assure that the credit is used to stimulate new construction and does not accrue disproportionately to existing low-income property. In this view, the waiver is inappropriate because the credit authority could be better utilized to generate new low-income units as opposed to further subsidizing relatively new existing units or State governmental bodies.

To the extent that a State has unused credit authority available, the use of the credit on buildings which receive the waiver may increase low-income housing by preventing conversion or, at worse, subsidizing the housing authority. However, if a State is already allocating the maximum credit available, then the use of credit authority on property receiving the waiver will displace other low-income housing property. The net impact on available housing de-

pends on the relative increase provided by alternative projects. The stock of low-income housing in this situation may increase or decrease because of the availability of the waiver, but the net effect of the eligibility waiver for areas which are already allocating all credits may be small.

Limited equity housing cooperatives

H.R. 3663 would waive the requirement that no more than 20 percent of income for limited equity housing cooperatives may be from nonmembers. It also provides for the treatment of mandatory reserves as member-source income.

Some believe that ownership by low-income residents of their own property should be increased. The provisions in the bill may permit limited equity cooperatives to compete more effectively for ownership of their own residential property. The provisions also may increase cooperative viability and number of eligible properties by eliminating restrictions on cooperatives' capacity for using commercial income that may be inherent in the property owned. Some believe that particular properties may reasonably generate more than 20-percent commercial income without violating the intent of the cooperative provisions.

Alternatively, the limits that generally apply to other cooperatives also may be viewed as equitable for limited equity cooperatives. The 20-percent ceiling permits ample room for reasonable commercial activity, and, some would argue, violation of this limitation is indicative of a violation of the intent of the cooperative provisions in the Code. Likewise, they would consider investment activities as not being directly relevant to the purpose of the cooperative and therefore income from those investments as not deserving to be treated as member income.

APPENDICES

A. Economic Issues Arising from Tax Preferences for Low-Income Rental Housing

As is the case with direct expenditures, the tax system may be used to improve housing opportunities for low-income families either by subsidizing rental payments (increasing demand) or by subsidizing construction and rehabilitation (increasing supply) of low-income housing units.

Excluding the value of section 8 vouchers from taxable income is an example of a demand subsidy. By subsidizing a portion of rent payments, it enables beneficiaries to rent more or better housing than they might otherwise be able to afford. The low-income housing tax credit is an example of a supply subsidy. By offering a credit worth 70 percent of construction costs, it induces investors to provide housing which otherwise would not be built.

Efficiency of tax subsidies

Both direct expenditures and tax subsidies for rental payments may not increase housing consumption dollar for dollar. One study of the section 8 Existing Housing Program suggests that for every $100 of rent subsidy a typical family increases its expenditure on housing by $22 and increases its expenditure on other goods by $78.[15] While the additional $78 spent on other goods certainly benefits the family, the $100 rent subsidy does not increase their housing expenditures by $100.

The theory of subsidizing demand is that by providing low-income families with more spending power their increase in demand for housing will ultimately lead to more or better housing being available in the market. However, if the supply of housing to these families does not respond to the higher market prices that rent subsidies ultimately bring, the result will be that all existing housing costs more, the low-income tenant will have no better living conditions than before, and other tenants face higher rents. The benefit of the subsidy will accrue to landlords because of the higher rents.

Supply subsidy programs can suffer from similar inefficiencies. If a developer had planned to build low-income rental units prior to the creation of the low-income housing credit, he may now find that his project qualifies for the credit. That is, the subsidized project may displace what otherwise would have been an unsubsidized project. If this is the case, the tax expenditure of the credit will result in little benefit except to the extent that the credit's tar-

[15] *See*, W. Reeder, "The Benefits and Costs of the Section 8 Existing Housing Program," *Journal of Public Economics*, 26, 1985.

geting rules may force the developer to serve lower income individuals than otherwise would have been the case.

One study of government subsidized housing starts between 1961 and 1977 suggests that as many as 85 percent of the government subsidized housing starts may have merely displaced unsubsidized housing starts.[16] This figure is based on both moderate- and low-income housing starts, and therefore probably overstates potential inefficiency of tax-subsidies to low-income housing. Displacement is more likely to occur when the subsidy is directed at projects the private market would have produced anyway.[17] Displacement is also more likely to occur where the number of subsidies granted is small relative to private market activity since there is more possibility for substitution.

Neither of these effects is likely with regard to tax-based supply subsidies to low-income housing. Many believe that the private market would not otherwise build new housing for low-income individuals because it is unprofitable. Consequently, tax-subsidized low-income housing starts might not displace unsubsidized low-income housing starts.

The tax subsidy to low-income housing could displace construction of other housing. Constructing rental housing requires specialized resources. A tax subsidy to low-income housing may induce these resources to be devoted to the construction of low-income housing rather than other housing. If most of the existing low-income housing stock originally was built to serve non-low-income individuals, in the long-run a tax subsidy to low-income housing could ultimately displace some privately supplied low-income housing.

Targeting the benefits of tax subsidies

Since the basic principle of demand subsidies is to put more cash in the hands of consumers, targeting the recipients of the subsidy is not a difficult job. For example, the use of a tax deduction or tax credit could be limited to individuals whose income is less than some specified amount. However, such demand-side tax subsidies are not without problems for targeting recipients.

If a low-income tax subsidy is structured as a tax deduction, many low-income individuals might not be able to take advantage of the subsidy. Utilizing a tax deduction requires taxable income, and the Tax Reform Act removed many low-income families from the tax rolls. Even if the tax subsidy was structured as a credit, the credit would have to be refundable for any of the potential benefits to reach low-income families.[18] Even if refundable, some low-income families either may not file tax returns or not be aware of their eligibility for such a credit and as a result the potential benefits could go unclaimed. If refundable, to aid in meeting rent com-

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[16] *See* M. Murray, "Subsidized and Unsubsidized Housing Starts: 1961-1977," *The Review of Economics and Statistics*, 65, November 1983.

[17] For example, a mortgage subsidy for single family housing may be a ready substitute for conventional mortgages available in the private market place. The effect of the subsidized mortgage may be to reduce the supply of unsubsidized mortgages since ultimately the money is borrowed from the same pool of private investors.

[18] Refundable tax credits (other than the earned income credit) are treated as direct outlays in the budget process.

mitments, a demand-side tax credit would have to be payable more frequently than annually. This would require creating a distribution system to get the funds in the hands of the recipients. This could be an administratively difficult task, particularly if the recipient is unemployed.[19] Thus, a demand subsidy may be administered most efficiently as a spending program (e.g., section 8 vouchers) rather than through the tax system.

Targeting the recipient of a demand-side tax subsidy does not necessarily result in targeting the benefit of the subsidy. As discussed above, if market supply does not respond to the increase in demand which the subsidy creates, the benefit of the subsidy would flow to landlords in the form of higher rents. Even if as a result of the subsidy, recipients can successfully buy more or better housing, because demand subsidies are rarely fully efficient some of the benefit of the subsidy will not be spent on housing.

On the other hand, a supply subsidy to housing will be spent on housing; although, as discussed above, this may not be in addition to housing spending that would have accurred in the absence of the subsidy. However, to insure that the housing, once built, serves low-income families, income targets and rent limitations for tenants must be attached as is the case for demand subsidies. While an income limit may be effective in targeting the benefit of the housing to lower income levels than would an unrestricted market, it may best serve only those families at or near the income limit. If, as with the low-income credit, rents are restricted to a percentage of targeted income, the benefits of the subsidy may not accure equally to all low-income families. Those with incomes beneath the target level may pay a greater proportion of their income in rent than does a family with a greater income. On the other hand, to the extent that any new, subsidy-induced housing draws in only the highest of the low-income families, it should open units in the existing low-income housing stock for others.

Even though the subsidy may be directly spent on housing, targeting the supply subsidy does not necessarily result in targeting the benefit of the subsidy to tenants. Not all of the subsidy will result in net additions to the housing stock. The principle of a supply subsidy is to induce the producer to provide something he or she otherwise would not. Thus, to induce the producer to provide the benefit of improved housing to low-income families, the subsidy must provide benefit to the producer.

Targeting tax incentives according to income can result in creating high implicit marginal tax rates. For example, if rent subsidies are limited to families below the poverty line, when a family is able to increase its income to the point of crossing the poverty line the family may lose its rent subsidy. This loss of rent subsidy is equivalent to a high rate of taxation on the family's additional income. The same may occur with supply subsidies. With the low-income housing credit the percentage of units serving low-income families is the criteria for receiving the credit. Again, the marginal tax rate on a dollar of income at the low-income threshold may be very high for prospective tenants.

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[19] The earned income credit is payable to the employee in his paycheck.

Credits v. deductions

A tax subsidy may be structured as either a deduction or a credit. Because taxpayers face different marginal tax rates, deductions yield different dollar amounts of tax benefits depending upon the taxpayers tax bracket. In the case of a demand subsidy this means that as the taxpayer's income, and marginal tax rate, increases his tax subsidy increases. The bigger subsidy can go to the wealthier individual.

In the case of a supply subsidy which is a deduction, if both a high tax bracket and a lower tax bracket supplier fund it profitable to use the deduction and provide low-income housing, the lower tax bracket supplier will have supplied the housing at less cost to the government, even though they both provide the same amount of housing. This is because for the same dollar amount of deduction, the high tax bracket supplier of housing receives more dollars of tax benefit than the lower tax bracket supplier.

Credits yield the same dollar of tax benefit to all recipients and therefore do not suffer the problems associated with deductions.[20] The low-income housing credit yields the same tax benefit to all investors.

[20] This is not strictly true if the taxpayer has an insufficient tax liability to utilize the credit and the credit is not refundable.

B. Overview of Federal Low-Income Rental Housing Assistance Programs

1. Legislative background of direct expenditure programs

Pre-1974 legislation

Federal participation in the provision of low-income rental housing began with the United States Housing Act of 1937.[21] This law provides Federal assistance for the construction of low-rent projects which were developed, owned and operated by State-chartered, local public housing agencies. Federal assistance is given by annual payments made under an annual contributions contract. The subsidy covers the payment of annual interest and amortization of bonds or notes issued by the public housing agency.[22] In response to inflation in the 1960s, tenant rent payments were limited to no more than 25 percent of income and HUD was authorized to pay operating costs of projects to make up for the loss of income incurred by the public housing agency because of the limitation on rent payments.

Section 221(d)(3)

The Housing Act of 1934 established the section 221 mortgage insurance program providing assistance for construction and rehabilitation of housing for displaced persons. This assistance was extended to low- and moderate-income families in the Housing Act of 1961 when the program was extended beyond mortgage insurance to the subsidization of mortgage interest charges.

Section 202

Efforts to broaden the number of people served by the 1937 Act led to other assistance programs being added through time. These assistance programs generally relied upon reducing the financing costs of new construction. For example, section 202 of the Housing Act of 1959 provided direct loans for construction of rental units for elderly families. Construction and permanent financing loans are given for the development of rental units. As revised through the years, this is a program for lower-income handicapped persons and families in addition to the elderly.

Section 236

In 1968, housing legislation enacted the section 236 program which provided subsidies to developers of rental units. The subsidies were in the form of an annual interest payment to the private

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[21] For a more complete discussion of these programs, *see*, G. Milgram, *Housing Assistance: A Brief History and Description of Current HUD Programs, supra.*

[22] In more recent years, HUD has been authorized to pay development costs through grants at the beginning of development, rather than through annual payments.

lender which reduced the effective rate of mortgage interest to one percent. Eligibility for residency in an assisted rental project was limited to families with incomes below 135 percent of maximum income for admittance to public housing in the particular area. Families then paid at least 25 percent of income for rent. A higher payment would be necessary if the interest reduction was insufficient to lower rents to an amount that could be covered by the 25 percent figure. Section 236 assistance superseded the similar section 221(d)(3) program.

In the early 1970s these housing programs came under criticism for being excessively expensive in both initial construction costs and operating expenses, and subject to unacceptably high rates of default and foreclosure. In response to the criticism, the administration imposed a moratorium on all new activities under the major subsidy programs after January 5, 1973. Since that time no additional units have been financed with section 236 rental housing assistance, although long-term contracts continue to be honored.

1974 Act—"Section 8"

The Housing and Community Development Act of 1974 created a new program popularly referred to as "section 8." This law amended section 8 of the Housing Act of 1937 to provide a payment made by HUD on behalf of the tenant to a landlord. The tenant must receive a certificate of eligibility from the local public housing agency and must find his or her own housing. The payment to the landlord is the difference between the tenant's rent payment, which is limited to 30 percent of the tenant's income, and the contract rent. The contract rent generally may not exceed the HUD established fair market rent. The law permits the subsidy amount to increase annually as rents in the local area increase.

1983 Act

Prior to the Housing and Urban-Rural Recovery Act of 1983 units could be in either existing housing, or in new construction or substantially rehabilitated unit which were built under a commitment from HUD that section 8 subsidies would be paid to eligible tenants when development was completed. The 1983 Act removed authorization for additional new construction or substantial rehabilitations.

Housing vouchers

A housing voucher program was adopted in 1983 as a demonstration program. It is technically a part of the section 8 program and is similar to the section 8 Existing Housing (Certificate) program in providing a subsidy for rent payments to landlords on behalf of tenants. In the voucher program, HUD pays the difference between 30 percent of the tenant's income and the HUD established fair market rent. Unlike the section 8 certificates, the tenant and landlord establish the contract rent, and may exceed the fair market rent. Consequently, the tenant may pay more than 30 percent of his income in rent.

Section 17

The 1983 Act created Rental Housing Rehabilitation and Production Grants. The rehabilitation part of the program provides grants for moderate rehabilitation of units in neighborhoods in which the median income is not greater than 80 percent of the area median income. The grant may finance no more than 50 percent of all costs and cannot exceed $5,000 per unit. Rehabilitations are restricted to correct substandard conditions, make essential improvements, or repair major systems in danger of failure. All assistance must benefit low-income families.

The program also makes available grants for new construction and substantial rehabilitation. Demonstration of a shortage of affordable rental housing, minimization of displacement, and contribution to neighborhood conservation constitute some of the many selection criteria.

Uniform requirements

As different programs were added in a piecemeal manner, different programs often had different eligibility or rent requirements. Now the requirements are uniform across programs. Eligible tenants must have incomes under 80 percent of the median income in the local housing market, adjusted for family size. The tenant's out-of-pocket contribution towards rent, which includes both payment for shelter and utilities, cannot exceed 30 percent of income.

2. Scope of housing programs

Section 8 is the program currently adding the most units to the subsidized housing stock. Nevertheless, conventional public housing houses the largest number of families. Currently, some 1.3 million families live in public housing units.[23] Tables 1 and 2 below show that expenditure on and growth of public housing has slowed considerably over the past 10 years.

By the end of fiscal 1986, 2.1 million units were eligible for receipt of a section 8 subsidy payment. More than half of these were in the existing housing program. Table 1 shows that growth of assisted units has slowed. Housing vouchers are funding larger proportions of section 8 assistance. In 1986, 36,000 of the units were assisted by vouchers, and it was planned that more than half of the newly assisted units in 1987 would be assisted by vouchers.[24] Table 2 documents the decline in expenditure on the section 8 program.

Table 1.—Newly Reserved Units in Public Housing and Section 8 Assistance, Fiscal Years 1977-1986

[Number of units in thousands]

Fiscal year	Total [1]	Total NC&SR [2]	Total existing	Section 8		Public housing
				NC&SR [2]	Existing	NC&SR [2]
1977	362.9	201.3	161.6	169.4	161.6	31.9
1978	313.9	178.4	135.5	122.0	135.5	56.3
1979	324.7	200.0	124.7	145.0	124.7	54.9
1980	205.9	129.4	76.5	97.8	76.4	36.7
1981	220.1	109.8	110.3	73.9	110.3	35.9
1982	145.5	39.6	105.9	27.5	105.9	12.1
1983	146.7	18.1	128.6	15.6	128.6	2.5
1984	151.7	21.8	129.9	14.4	129.9	7.4
1985	125.5	20.3	105.2	12.6	105.2	7.6
1986	106.3	17.6	88.7	11.5	88.7	6.1

[1] Until fiscal 1980, units reserved are reported on a net basis, exclusive of units recaptured from previous reservations. In fiscal 1981 and thereafter, the data are on a gross basis.

[2] New construction and substantial rehabilitation.

Source: G. Milgram, *Trends in Funding and Numbers of Households in HUD-Assisted Housing, Fiscal Years 1975-1987*, Congressional Research Service, Report 87-363E, May 5, 1987.

[23] *See*, G. Milgram, *supra*.

[24] *Ibid.*

Table 2.—Use of Budget Authority for Public Housing and Section 8 Assistance, Fiscal Years 1977-1986

[Dollar amounts in billions]

Fiscal year	Total [1]	Total NC&SR [2]	Total existing	Section 8		Public housing
				NC&SR [2]	Existing	NC&SR [2]
1977	$27.8	$21.8	$5.0	$18.9	$4.9	$3.0
1978	25.3	19.8	5.5	13.3	4.8	6.4
1979	28.2	23.1	5.1	16.4	5.1	6.7
1980	19.3	15.2	4.1	10.7	4.1	4.5
1981	21.0	14.9	6.1	10.2	6.1	4.7
1982	10.3	5.4	4.9	3.7	4.9	1.7
1983	8.6	2.3	6.3	2.0	6.3	0.3
1984	8.1	3.1	5.0	1.9	5.0	1.2
1985	7.8	2.7	5.1	1.5	5.1	1.2
1986	7.2	2.7	4.5	1.6	4.5	1.1

[1] Until fiscal 1980, units reserved are reported on a net basis, exclusive of units recaptured from previous reservations. In fiscal 1981 and thereafter, the data are on a gross basis.

[2] New construction and substantial rehabilitation.

Source: G. Milgram, *Trends in Funding and Numbers of Households in HUD-Assisted Housing, Fiscal Years 1975-1987, supra.*

Loans under section 202 have typically been combined with assistance under section 8. Loans under section 202 have also dwindled in recent years. In fiscal 1981, permissible loan funds reached their peak of $895.8 million. In fiscal 1987 loan funds were limited to $592.7 million (all figures are in nominal dollars). Nevertheless, by the end of fiscal 1986, 138,000 units had been completed with the assistance of section 202 funds in concert with section 8.

Approximately 600,000 units were built under the section 236 program of which 530,000 units remain in the program. Of this total, 180,000 receive section 8 assistance. Another approximately 70,000 units are in service with the assistance of section 221.

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